South Jersey Gas

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VIA OVERNIGHT DELIVERY
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August 2, 2005

Ms. Kristi Izzo
Board Secretary
State of New Jersey
Board of Public Utilities
Two Gateway Center
Newark, New Jersey 07102

Re: Focused Audit of Affiliated Transactions and Management Audit of South Jersey Gas Company by The Liberty Consulting Group
Docket No. AX04040277
Audit Recommendation Suggested Clarifications and/or Exceptions

Dear Ms. Izzo:

As requested by Board staff, we are providing you with our comments on the FINAL Focused Audit of Affiliated Transactions and Management Audit ("Audits" or "Report") of South Jersey Gas Company ("SJG" or "the Company"). We are providing you with an original and ten copies for filing with the Board and for inclusion in the FINAL REPORT.

The depth and breadth of these audits on the Company were extensive recognizing that in addition to Affiliate Standards audit items the scope included the Gas Supply function last audited over eight years ago, as well as overall Management and Operations last audited over 12 years ago. SJG commends the entire Liberty Consulting Staff as well as the BPU Staff for their professionalism and support throughout the audit. In fact, the thoroughness of the audits and overall results as described in Liberty's FINAL Audit Report have validated that SJG is in fact a well run company. As noted by Liberty in their Introduction to the Executive Summary, SJG is openly receptive to improvement opportunities and looks forward to working with the BPU to make appropriate changes happen.

Liberty's FINAL Audit Report is segmented into four volumes: Gas Supply; Cost Allocations and Affiliate Relations; EDECA and Affiliate Standards; and, Management and

Operations. Within each volume Liberty has presented their findings, conclusions and recommendations. In total, the report includes **136** recommendations of which SJG accepts a great majority, **118**, and agrees to take actions as necessary to implement those accepted recommendations. The Company respectfully disagrees with only **three** of the recommendations and **15** are accepted in concept with clarifications and/or exceptions.

In a separate correspondence, SJG addressed the **three** recommendations with which the Company respectfully disagrees. The remainder of this letter will address SJG's formal responses to the **15** recommendations with which the Company desires to provide suggested clarifications and/or exceptions.

COMMENTS ON RECOMMENDATIONS

Volume ONE: Gas Supply Audit Recommendations

Of the **39** recommendations within this volume of the final audit report, the Company is pleased to agree to implement all recommendations with only **three** suggested clarifications and/or exceptions as addressed below.

GS-20 Establish a mechanism for making marketer assets available to continue serving customers upon market exit or bankruptcy.

RESPONSE: The Company considers this as a recommendation to the NJBPU more than simply to SJG. Without considerable study and input from all current and potential third-party gas supply market participants throughout New Jersey this is not actionable as stated. The recommendation has far-reaching implications on the entire third-party gas supply market which are beyond either the ability or the prerogative of SJG to implement. To the extent that the NJBPU desires to proceed with the implied market changes, SJG will fully participate in all necessary proceedings.

GS-22 Develop procedures and ground rules for negotiating flex-rate contracts.

RESPONSE: The Company agrees with the concept of the recommendation. However, written procedures and guidelines will serve little to no benefit to the negotiation of flex-rate contracts. SJG currently has only seven flex-rate contracts in place with no indication of further contracts in the near term. Of those that exist, each has its own set of circumstances, not lending itself to a common set of procedures or guidelines beyond what already exists in SJG's Tariff.

GS-38 Re-evaluate and reformulate marketing goals for interruptible service customers.

RESPONSE: The Company agrees with the intent of the recommendation. As SJG reformulates marketing goals, the Company will develop an appropriate mix of programs consistent with the tariff requirement to provide customers with the best match of tariff provisions with their individual needs. Sales associates have incentive plans that are likewise driven by customer needs within the framework of tariff provisions.

Volume TWO: Cost Allocations and Affiliate Relations Audit Recommendations

Of the **12** recommendations within this volume of the final audit report, the Company is pleased to agree to implement all recommendations with only **three** suggested clarifications and/or exceptions as addressed below.

CA-4 Distribute the tax benefits that SJI realizes from the ESOP and 401(k) plan in a manner that reflects which entities caused the benefit and by how much, and revise SJG's books for 2004 accordingly.

RESPONSE: The Company agrees with Liberty's conclusion that SJI erred in not sharing tax benefits with its subsidiaries, and further agrees to implement the recommendation on a going-forward basis. However, the requirement to revise the Company's financial statements for 2004 has far reaching financial implications which are not justified simply to fix this item.

CA-8 Enter no more relationships in which an SJI company or related company provides utility type services to SJG.

RESPONSE: The literal wording of the recommendation categorically prohibits the Company from ever entering into this type of transaction. Liberty's discussion of the recommendation does state that SJG may enter into such a relationship with the approval of the Board. The Company agrees that a review of the proposed transaction with the Board is appropriate prior to initiation of the relationship but disagrees with the absolute prohibition.

CA-12 Devote a full-time equivalent person to assuring that the tasks of distributing costs among affiliates are done in a timely manner.

RESPONSE: The Company agrees with the intent of this recommendation; however, the method and systems by which cost allocations are performed and monitored remains the prerogative of management. Given an appropriate mix of systems and oversight, an additional full-time equivalent person would be underutilized and inefficient.

Volume THREE: EDECA and Affiliate Standards Audit Recommendations

Of the **35** recommendations within this volume of the final audit report, the Company respectfully disagrees with only **two**, addressed by separate correspondence, and is pleased to agree to implement the remaining **33** recommendations with no additional suggested clarifications and/or exceptions.

Volume FOUR: Management and Operations Audit Recommendations

Of the **50** recommendations within this volume of the final audit report, the Company respectfully disagrees with only **one**, addressed by separate correspondence, and is pleased to agree to implement the remaining **49** recommendations with only **nine** suggested clarifications and/or exceptions as addressed below.

MO-2 <u>Eliminate the requirement that the Nominating and Governance Committee take counsel from inside directors in recommending committee chairs to the full board.</u>

RESPONSE: The Company agrees with the intent of this recommendation. However, the Chairman and CEO of the Company needs to be a part of the process of selection of Committee chairs. The process must be a collaborative one.

MO-12 <u>Include formal contingency planning, and generate 12 to 18 month rolling-forward forecasts to enhance the ability to assess the realism of future expectations.</u>

RESPONSE: While the Company agrees with the part of this recommendation to include formal contingency planning, the further recommendation to generate 12 to 18 month rolling-forward forecasts is an unnecessary administrative burden – one that is not easily (if at all) supported by current or planned financial systems. Additionally, sufficient internal processes already exist, some the result of Sarbanes-Oxley 404 implementation, to assess the realism of future expectations.

MO-24 <u>Complete SJG's implementation of the Lawson system this year.</u>

RESPONSE: While the Company agrees with the intent to increase focus on the implementation of the Lawson system, the recommended time frame of "this year" is not reasonable. During 2005, SJG intends to develop the cost-center accounting & reporting discussed in the audit report; further leverage the features of the General Ledger and the Project & Activity module that were installed during the second half of 2004; and install the Lawson inventory module. The final module currently planned for installation is the Capital Asset System that will be evaluated during 2005 but the resources (personnel) to install the module will not be available until 2006.

If SJG accelerates the installation schedule to include all modules in 2005, the full functionality of the existing systems would not be realized in a timely manner and the remaining installations would run the risk of not being designed optimally.

MO-25 <u>Implement cost-center accounting for SJI and the other affiliates this year.</u>

RESPONSE: As with the MO-24 response above, the Company agrees with the intent to increase focus on the implementation of the Lawson system across all SJI companies; however, the recommended time frame of "this year" is not reasonable. Current plans are to complete SJG cost-center accounting during 2005 and then to move forward with SJI since that is the only other entity allocating costs to SJG. Installation of the Lawson cost-center accounting system within SJI may be possible during 2005, but could continue into 2006. The other entities would follow after SJI's system is complete and functional. This would likely be in 2006.

MO-37 <u>Increase the SJG workforce or supplement it with contract labor to address growing backlogs.</u>

RESPONSE: While the Company agrees with the basis for this recommendation – that backlogs deserve management attention – the suggestion to simply increase workforce is not necessarily the best solution. Further, the Company strongly

disagrees with the Liberty assertion that we have had difficulties in complying with Federal DOT and NJ BPU regulations. SJG continuously monitors workload and performs manpower assessments to ensure the proper staffing levels. Contractors are utilized routinely for supplementing our workforce. In fact, the majority of SJG's construction activity is contracted to outside vendors. Additionally, contractors have been and will continue to be utilized, when required, in other areas of the Company's operations, such as new business meter installations, leak survey, and even leak repair.

System Operations has risk management tools in place to aid in the decision making process for managing and maintaining our system. Current positive union relationships have in fact increased our flexibility by allowing the utilization of union employees to perform work outside of their normal scope of work, such as meter changes, shut-off for non-payments and the routine turn-on and shut-off work. Additionally, SJG has been able to utilize Company employees to perform new-business service installations through the increased workforce flexibility.

MO-38 <u>Develop leak repair timeframes to ensure the prompt repair of "B" leaks.</u>

RESPONSE: The Company agrees in concept with this recommendation to develop leak repair timeframes around our backlog of "B" leaks. However, Liberty further recommends that "B" leaks (grade 2 leaks) must be repaired within 12 months at a minimum. The combined use of the System Operations risk management tools discussed under the response to MO-37 above as well as a planned thorough analysis of our "B" leak backlog will establish the most appropriate timeframe guideline for the SJG system.

MO-43 <u>Reprioritize calls so that SJG customers do not receive a lower level of service than do SJESP customers.</u>

RESPONSE: The Company agrees that SJG customers should not receive a lower level of service than do SJESP customers. It must be noted that SJESP customers have already waited 2 minutes in the SJESP system prior to the transfer to SJG. This wait time, added to the SJG response time, results in an overall wait time for SJESP customers greater than that of SJG. Also, the overall response for SJG continues to improve. The first quarter response time for SJG has been 36 seconds overall and 51 seconds for live agent calls.

MO-44 <u>Continue to research customer research to better understand customer expectations and perceptions.</u>

RESPONSE: The Company agrees with the intent of this recommendation. However, we would like to clarify that SJG implemented a customer satisfaction initiative in July 2004 in response to the high level of escalated complaints. Root causes of complaints were determined and processes changed as a result. The results have been significant in the reduction of complaints. From August 2004 through December 2004 we experienced a 46% reduction compared with the same period in 2003. Additionally, for the first quarter of 2005 vs. 2004, there has been a

69% reduction. We have also implemented a quarterly customer satisfaction survey to track our performance and measure customer expectations.

MO-45 Place responsibility for administering executive compensation with the assistant vice president for human resources, the company's officer responsible for managing the compensation of all other management personnel.

RESPONSE: While the Company understands the reasoning behind this recommendation, and agrees that the assistant vice president for human resources should have a role in the administration of executive compensation, the overall responsibility for this administrative function should remain at the executive level.

Once again, SJG would like to compliment Liberty Consulting and BPU Staff on the completion of a thorough and extensive series of audits on all aspects of the Company's operations. If you have any questions, please do not hesitate to contact me.

Sincerely,

David A. Kindlick
Executive Vice President and
Chief Financial Officer

Copy: Walter Szymanski, BPU Division of Audits
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